Trend Macrolytics, LLC
Donald Luskin, Chief Investment Officer
Thomas Demas, Managing Director
Michael Warren, Energy Strategist

TRENDMACRO LIVE!

On the March FOMC

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Donald Luskin

Powell brings the whole FOMC on his apology tour. Mystery remains for the balance sheet.

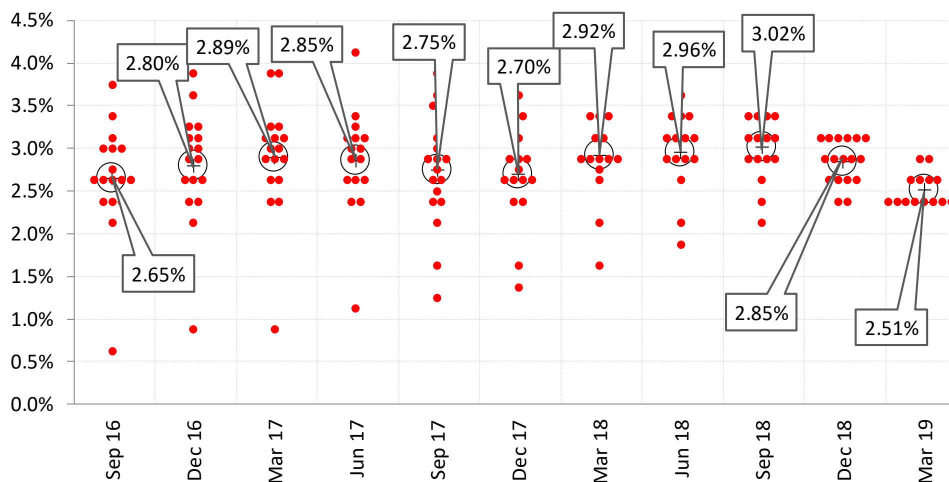
Click to watch short video about the Fed

[All videos]

Can there now be any doubt that Fed chair Jerome Powell cut a deal with President Donald J. Trump over the Christmas weekend (see "Did Powell Just Cut a Deal?" December 23, 2018)? And it seems Powell has dragged the whole FOMC along into a new world of born-again dovishness. *According to a new normalization policy published today, run-off of the Fed's Treasury and MBS holdings will slow in May to $35 billion per month, from $50 presently – halting entirely in September, at a level of holdings we estimate will be about $3.5 trillion. The "dot-plot" in today's Summary of Economic Projections moved the FOMC's estimate of "optimal policy" for 2019 from two rate hikes to not even one – the lowest estimate for 2019 since the exercise began back in September 2016* (please see the chart below). *Dots for 2020, 2021 and the "longer run" moved lower as well* (see "Data Insights: Federal Reserve" March 20, 2019).

- As of this writing, we note that it seems Powell has broken his losing streak in terms of bad stock market reaction to his FOMC

● FOMC participants assessments of appropriate funds rate for 2019 ○ Average



Source: FOMC Summary of Economic Projections, TrendMacro calculations

Update to strategic view

US FED, US MACRO, US BONDS: More "patience," with the 2019 "dot-plots" moving down to show not even a single rate hike. It's unanimous: the whole FOMC has joined Powell on his post-December apology tour. A new normalization policy statement today makes it official that run-off of Fed's asset portfolio will be tapered from May to September, and stop at a level of about $3.5 trillion. Maturing and prepaying MBS will be reinvested in Treasuries with an average maturity equal to overall Treasuries outstanding. There is still no plan for the maturity structure of the portion of the Fed's portfolio currently in Treasuries. No surprise that equity markets would be cheered by evidence that the rogue chair has been reined in. But this emphatic dovishness, and the bias toward a shorter-maturity balance sheet, ought to point to higher long-term Treasury yields, not the lower ones we saw today in reaction.

[Strategy dashboard]

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meetings (see “On the January FOMC” January 30, 2019). That makes sense, considering that the risk to growth of a rogue Fed chair that seemed so salient in December has definitively receded. *But we find the reaction by long-term bonds – a sharp drop in the 10-year Treasury yield – to be quite puzzling, and we expect it will be reversed. Bonds seem to be continuing to take their cue as to future economic prospects from the Fed – which seems to us like an inexplicable reliance, given the Fed's terrible forecasting record. In our framework, the intensifying dovishness of the Powell Fed ought to be supportive of both more robust growth and more robust inflation, which ought to point to higher yields – as we continue doggedly to expect they will. Order-flow arguments, which we don't usually like – point the same way, with indications today that the average maturity of the Fed's portfolio will decline over time, which would seemingly put upward pressure on longer-term Treasury yields.*

For all the increasing clarity we are now getting on the Powell Fed, the critical policy battleground remains the balance sheet.

- We've known since the minutes of the December FOMC meeting that its normalization at $50 billion per month of maturity-driven run-off is not, in fact, on “autopilot” – despite Powell's outrageous gaffe at the December press conference that it was. Powell's press conference at the January FOMC, and that meeting's minutes had already made it clear that the run-off will end this calendar year – and now it's official.
- This should be a great comfort to our many clients who believe that the sheer size of the Fed's balance sheet, in and of itself, is an essential liquidity lifeline to the global economy.
- *Our view is that size matters – if for no other reason than that the Fed now needs a large balance sheet so that its policy instrument, interest on reserves, will have a sufficiently large pool of assets on which to operate in order to effectively influence rates throughout the economy.* Incidentally, today's new normalization policy makes it crystal clear, at last, that this is, in fact, the operative policy consideration – Powell has been unable, so far, to articulate it.
- *But the composition of the balance sheet matters too. When the Fed buys long-term Treasuries and mortgage-backed securities, it is taking duration risk, prepayment risk and credit risk out of the private economy and storing it on its own balance sheet.*
- *When the economy is pathologically risk-averse, this de-risking exercise gives the private sector a breathing-spell, and a reinvigorated risk-budget with which to pursue growth ventures.*
- This is, in essence, Ben Bernanke's “portfolio balance channel.”
- Later, when the economy is normally risk-tolerant, the Fed's balance sheet may shrink, returning that duration risk, prepayment risk and credit risk to the private sector. *Such a shrinkage of Fed assets will not unwind the benefits of the initial intervention, because the economy's attitude toward risk will have fundamentally changed – at the outset, it desperately needed to be de-risked, and later it really doesn't care that much*.

Contact TrendMacro

On the web at
trendmacro.com

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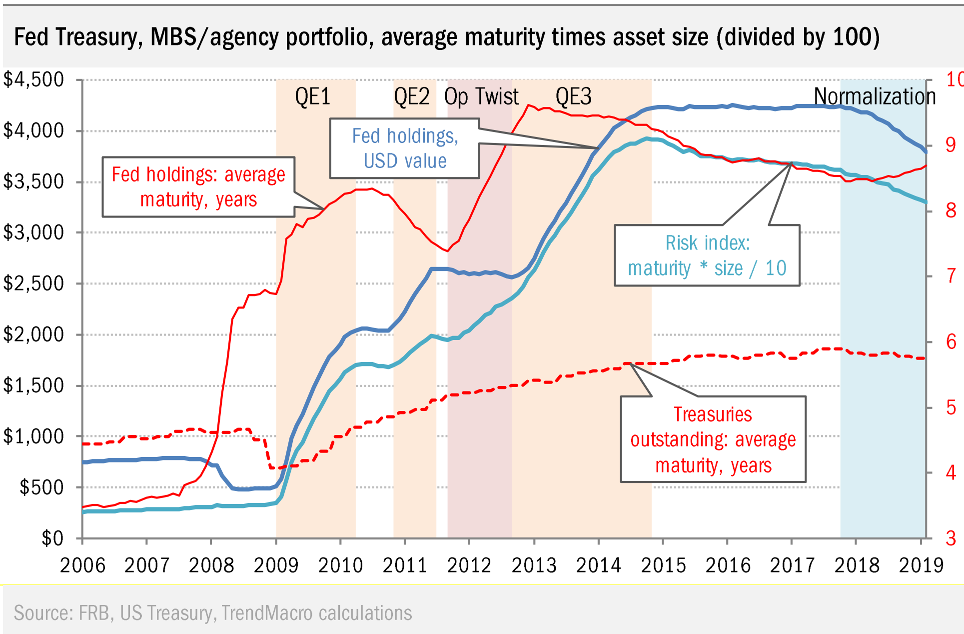
Donald Luskin
Chicago IL
312 273 6766
don@trendmacro.com

Thomas Demas
Charlotte NC
704 552 3625
tdemas@trendmacro.com

Michael Warren
Houston TX
713 893 1377
mike@trendmacro.energy

[About us]



- *For the process to work, the Fed's asset portfolio must be both large and risky. We know now that it will continue to be large. We don't know the extent to which it will continue to be risky.*
- A rough-and-ready way to capture the intersection of size and risk for the Fed's asset portfolio is simply to multiply its average maturity by total portfolio size, to create a "risk index" (we then divide by 10, for a more pleasing scale). This doesn't capture the credit risk in the Fed's MBS portfolio, but it's a decent proxy for overall duration risk. *Think of it as an index of the scope of stimulative power of the Fed's balance sheet to re-risk the economy.*
- Not a lot of people realize that while the *size* of the Fed's portfolio stabilized in November 2014 when QE3 completely sputtered out, *a stealthy program to reinvest maturing long-term Treasuries in short-term ones steadily lowered the average maturity of the Fed's portfolio, reducing the "risk index" even while it appeared on the surface that the Fed was standing pat* (please see the chart on the following page).
- If you believe in "quantitative tightening," this is actually when it began – almost three years before the Fed let the size of its portfolio shrink by even a single dollar (see "It's Not 'Quantitative Tightening' – It's Powell" December 20, 2018).
- *Once formal normalization began in September 2017, the average maturity of the Fed's portfolio began to rise*. This shouldn't be counterintuitive. It's a straightforward result of the regime of non-reinvestment of maturities – obviously, *more short-term Treasuries are going to mature than long-term ones. When their maturity payments go un-reinvested, the residual portfolio's average maturity rises* – on autopilot, as it were. Of necessity, this will continue as long as the Fed fails to reinvest maturities, which we know now will be September.
- Incidentally, in today's FOMC press conference, Powell was asked

a rather silly question by an NPR reporter, about why the average maturity of the portfolio has been allowed to rise despite the "fact" that this is contributing to the flattening of the yield curve. Powell wisely ducked the question at first, but the persistent reporter asked it again, and Powell wasn't bright enough to duck it a second time. He said something to the effect of, "Well, when a 10-year Treasury matures you invest it in another 10-year Treasury." We think we know what he was trying to say, and it is correct – sort of. Sadly, the poor fellow speaks economics as a second language, and just can't quite express these things in a way people can understand.

- *Since the onset of normalization, the "risk index" has continued to fall, but less steeply than it would have if the portfolio's average maturity hadn't been rising to partially offset the reduction in size*.
- *After September, the size of the Fed's balance sheet will stop shrinking. The Fed may elect to continue to reduce the average maturity of the portfolio, but at that point, that will be the only factor impacting the "risk index" – and it will be glacial, so long as the Fed does it only as longer-term assets mature.*
- We know from long-standing published normalization policy that the Fed plans on ending up with a portfolio of only Treasuries – that is, no MBS – and this was reaffirmed in today's new normalization policy. *So the credit-risk contained in the Fed's present $1.6 trillion MBS portfolio will eventually find itself back into the market on some unknown schedule – but unless there are outright sales, it will take decades to complete.*
- The new policy discloses that proceeds from maturing and prepaying MBS will be reinvested in a portfolio of Treasuries with the same average maturity as overall Treasuries outstanding.
- But we still have no idea how maturing Treasuries will be reinvested. We do know from the discussion at the December FOMC that there are at least two streams of thought about the ultimate average maturity of the Fed's portfolio. From the December minutes:

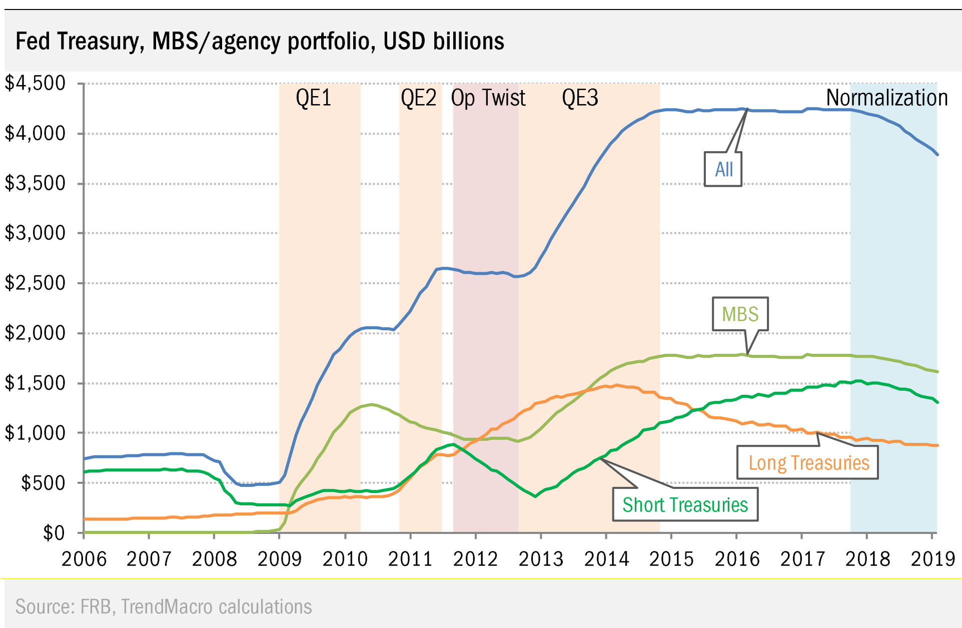
  "…participants discussed the advantages of different portfolio maturity compositions. Several participants noted that a portfolio of holdings weighted toward shorter maturities would provide greater flexibility to lengthen maturity if warranted by an economic downturn, while a couple of others noted that a portfolio with maturities that matched the outstanding Treasury market would have a more neutral effect on the market."

- Sound familiar? That argument about "greater flexibility" is the balance sheet version of the idea that the Fed should hike the funds rate simply so it can lower it later – seemingly without regard to the deleterious effects of having hiked it in the first place. That might imply reducing the average maturity of the Fed's Treasury portfolio from the present 7.8 years to, say, 3.5 years where it was before the Global Financial Crisis (again, please see the chart on the previous page)
- But it's not quite that brainless. With the balance sheet, remember it may be nearly costless for the Fed to reduce its portfolio maturity

when the market is risk-tolerant. If there's a flaw in the argument, it's that the portfolio's maturity must first be reduced at all in order to lengthen it later – if need be, it can be lengthened at any time simply by buying more assets, provided they are longer-term ones. So why take the chance of reducing it, just in case the economy isn't as risk-tolerant as you might think?

- The other idea expressed in December – a portfolio maturity that matches that of the outstanding Treasury market – is what was announced today for the proceeds of maturing and prepaying MBS. If that were applied to Treasuries as well, that would imply reducing the average maturity of the Fed's total portfolio from the present 8.7 years to 5.7 years (again, please see the chart on the previous page).
- *There is no third alternative in the December minutes. So given that we already know that the MBS portfolio with its present average maturity of 9.9 years is headed, over time, to the outstanding Treasury average of 5.7 years, we know that overall the average maturity of the Fed's portfolio is going lower. Too bad the FOMC doesn't even seem to be considering the benefits of having the Fed exploit its status as public institution of notionally infinite lifespan, which puts it in an ideal position to fund long-term assets with short-term deposits, earning a handsome spread that can be remitted each year to the US Treasury.*
- *But of the two options discussed, happily the one closest to the unexplored optimal third one looks like it will be chosen – it already has been, for reinvestment of MBS.*
- Whatever the Fed may do by way of reducing the average maturity of its portfolio, it will be a glacial process, so long as it is limited by the opportunity to reinvest maturities – as opposed to outright sales. Also, it is a process that can be stopped and restarted – that is, it's not on autopilot – as circumstances and acquired experience may dictate.
- To be sure, the Fed need not be limited in its maturity-shortening

Fed Treasury, MBS/agency portfolio, USD billions



Source: FRB, TrendMacro calculations

process by waiting for maturities – it could sell long-term assets outright, and replace them with shorter-term ones, like running "Operation Twist" in reverse. Today's new normalization policy pretty much rules out sales for MBS. We would guess that such a thing is highly unlikely in the future for Treasuries, as well. It is certainly off the table at the moment, at least for a Powell Fed still doing an apology tour, and bending over backwards to convince the market that it is "patient."

- Even if the Fed wanted to undertake outright sales, those would likely be limited to the $872 billion of longer-term Treasuries it now holds (amazingly, that's $382 billion *less* than before QE3 had even begun – please see the chart on the previous page).

Bottom line

More "patience," with the 2019 "dot-plots" moving down to show not even a single rate hike. It's unanimous: the whole FOMC has joined Powell on his post-December apology tour. A new normalization policy statement today makes it official that run-off of Fed's asset portfolio will be tapered from May to September, and stop at a level of about $3.5 trillion. Maturing and prepaying MBS will be reinvested in Treasuries with an average maturity equal to overall Treasuries outstanding. There is still no plan for the maturity structure of the portion of the Fed's portfolio currently in Treasuries. No surprise that equity markets would be cheered by evidence that the rogue chair has been reined in. But this emphatic dovishness, and the bias toward a shorter-maturity balance sheet, ought to point to higher long-term Treasury yields, not the lower ones we saw today in reaction.